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I. Introduction: What is the problem?

The costs associated with implementing the requirements of the Sarbanes-Oxley Act of 2002 (SOA)[1] are leading to a movement by small, publicly traded companies[2] to de-register from national exchanges and to "go private."[3] In the eighteen months after the SOA was passed, 146 firms filed the forms required by the Securities and Exchange Commission (SEC) to go private, compared to just ninety-seven in the nineteen months before the passing of the SOA.[4]

Congress did not necessarily foresee this problematic phenomenon in its haste to pass the SOA.[5] Moreover, despite an abundance of

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1. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 (2003).

2. For the purposes of this comment, the definition of small public companies is generally equivalent to that of "small cap" companies. In defining "small cap" companies:

> "Cap" refers to the market *capitalization* or the value of a company's outstanding equity. This is the most common measure of size used to discriminate between companies that have issued stock, and is calculated by multiplying the total number of shares outstanding by the share price. No consensus exists as to what constitutes a small cap company. Generally the term refers to companies whose size ranks at or below the levels of the smallest 20% of companies listed on exchanges such as the NYSE, the NASDAQ and the AMEX.

Frank Hernandez, *Going Private: Responding to the Small Cap Dilemma,* IV SIA RESEARCH REPS. 8, 3 (Aug. 21, 2003).

3. *See* definition of "going private" *infra* Part II.D.

4. ELLEN ENGEL ET AL., THE SARBANES-OXLEY ACT AND FIRMS' GOING-PRIVATE DECISIONS 12 (Univ. of Chicago, Graduate School of Business, Working Paper Oct. 29, 2004), *available at* http://accounting.wharton.upenn.edu/seminar/ehw-gp04.pdf (last visited Jan. 18, 2005) (on file with author).

5. *See* Alix Nyberg, *Sticker Shock,* CFO MAGAZINE (Sept. 01, 2003), http://www.cfo.com/article/1,5309,10546,00.html?f=insidecfo (stating that many finance

evidence about the strain the SOA is causing small companies, lawmakers are not ready to acknowledge any problem with the law.[6] The SEC, the agency to which Congress delegated responsibility to implement and carry out the SOA's requirements,[7] along with Congress, must soon recognize the special difficulties small companies are facing and provide a remedy.

Going private is a legitimate business solution for certain public companies. As revealed in Part II of this comment, however, the problem associated with going private is that it should not be used by most public companies simply to escape the current costs of being public.[8] There is an impetus toward going private by small public companies whose principal motivation to do so is the increased regulation associated with the SOA.[9] This impetus is likely to diminish once the SOA is fully understood, and those companies that go private now risk losing all the advantages of being public that led them to the public markets in the first place. Nevertheless, the SOA is overly burdensome on small public companies because of the fixed costs involved in implementing the law; the SEC or Congress should provide some relief for these companies.

Part II analyzes the sections of the SOA that will affect the bottom line of companies of all sizes and attempts to point out the flaws in the SOA that lead to disproportionate compliance costs for small public companies. Although the SOA is certainly not the only factor causing companies to remove themselves from the public equity markets, it is a primary factor. Additional factors, such as new more stringent rules implemented by the New York Stock Exchange (NYSE) and the inter-dealer quotation system, the National Association of Securities Dealers Automated Quotation (NASDAQ), are also discussed in Part II as reasons motivating small companies to go private. Part II also addresses the state of the economy and the evolution of popular perceptions about what it means to be public, as factors influencing going private decisions. Part II explains the problematic but popular solution of going private, along with the reasons for the solution's popularity and its problems.

The primary contention of this comment, discussed in Part III, is that going private as a result of the SOA is usually unnecessary, is

executives and attorneys such as Goodwin Procter LLP partner Steve Poss, believe that "by rapidly legislating a whole set of processes, the law has become a windfall for auditors and lawyers and a time drain on overburdened finance departments").

6. *See* STAFF OF HOUSE COMM. ON FINANCIAL SERVICES, 108TH CONG., REBUILDING INVESTOR CONFIDENCE, PROTECTING U.S. CAPITAL MARKETS: THE SARBANES-OXLEY ACT, THE FIRST YEAR (Comm. Print 2003).

7. Sarbanes-Oxley Act § 3, 15 U.S.C. § 7202.

8. *See infra* Part III.A.

9. *See infra* notes 44-46 and accompanying text.

fraught with danger to minority shareholders, and can actually be harmful to the long-term prospects of a small public company. Part III also includes a proposed solution, which is based on differing levels of regulatory and national exchange compliance for small companies, to the problem of over-regulation of small public companies. Part IV concludes by providing a brief summary of this comment and a suggestion for an exercise of patience by small public companies burdened by the SOA.

II. Background

A. The SOA and Other Factors Causing Companies to Go Private

The purpose of the SOA, as reported by Congress, is "to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility. . . ."[10] It is well documented that the primary "failures" Congress was reacting to by passing the SOA were the bankruptcies of Enron in December 2001 and Worldcom in July 2002.[11] One influential think-tank pegged the first-year cost to the United States economy of those two bankruptcies combined at $37 to $42 billion.[12] In its haste to respond to these financial and political catastrophes,[13] Congress passed the SOA and President George W. Bush enacted the law in July 2002.[14]

The spectacular story of Enron's collapse is familiar to most. Complex partnerships were set up to fraudulently hide losses and overstate earnings in order to cause an increase in share price.[15] When coupled with lax oversight by Enron's Board of Directors, these

10. *See* S. REP. NO. 107-205, at 4 (2002).

11. *See* REBUILDING INVESTOR CONFIDENCE, PROTECTING U.S. CAPITAL MARKETS, *supra* note 6 (literally illustrating those two mega-bankruptcies, along with Global Crossing); *see also* Scott Harshabarger, *Corporate America's New Accountability*, BOSTON GLOBE, Aug. 19, 2003, at A19.

12. *See* CAROL GRAHAM ET AL., THE BIGGER THEY ARE, THE HARDER THEY FALL (Brookings Inst. Working Paper, 2002) (measuring the impact of the Enron and WorldCom bankruptcies as they have affected the Gross Domestic Product).

13. A *Wall Street Journal* editorial opined that the SOA "was adopted hastily, and without adequate consideration by a Congress panicked about the possibility that the Enron and WorldCom cases had seriously weakened investor confidence." Peter J. Wallison, Editorial, *Blame Sarbanes-Oxley*, WALL ST. J., Sept. 3, 2003, at A16.

14. *See* REBUILDING INVESTOR CONFIDENCE, PROTECTING U.S. CAPITAL MARKETS, *supra* note 6.

15. *See* Joann S. Lublin, *Inside, Outside Enron, Audit Panel Is Scrutinized: Links to Company Of Certain Members Are Called Too Cozy*, WALL ST. J., Feb. 1, 2002, at C1 (discussing Enron's collapse, its re-statement of $600 million, and the corporate governance practices that led to the collapse).

fraudulent accounting practices resulted in huge losses.[16] These losses eventually led to the bankruptcy of the energy trading company, which was once Wall Street's darling, and to the loss of millions of dollars by investors.

The press has also told the story of Worldcom so many times that it too is now familiar to most. Considered the biggest accounting fraud ever, the events leading to Worldcom's bankruptcy are typical of the kind of behavior the SOA is meant to curb.[17] Essentially, "[w]hen a downturn in the broader market hurt WorldCom's stock . . . the company used accounting gimmicks to paper over losses and buoy its shares."[18]

B. The Requirements of the SOA and the Costs Associated with Compliance

The requirements of the SOA include: the establishment of a Public Company Accounting Oversight Board,[19] auditor independence,[20] and improved reporting of "financial results, commitments, transactions, relationships with entities, and uncertainties[,] . . . as well as matters that will have an impact on future operations. . . ."[21] For the purposes of this comment, only the requirements most likely to have a significant impact on small public companies will be discussed. These requirements include increasing and accelerating public disclosure requirements, hiring of new directors and financial experts,[22] training of staff, and the outsourcing of legal and accounting work.[23]

The requirements of the SOA that weigh most heavily on smaller companies are numerous. An initial requirement calls for the filing of statements reflecting transactions that involve management and principal stockholders.[24] Prior to the SOA, these statements were to be reported within ten days of the "close of the month in which the transaction occurred."[25] Following the implementation of the SOA, "insiders," such as management and principal stockholders, must file a statement within

16. *See id.*

17. *See* Ken Belson, *Superlatives (and Contradictions) in a Fraud Trial*, NY TIMES, Jan. 16 2005, at B1.

18. *Id.*

19. *See* Sarbanes-Oxley Act § 101, 15 U.S.C § 7211.

20. *See id.* §§ 201-209.

21. REBUILDING INVESTOR CONFIDENCE, PROTECTING U.S. CAPITAL MARKETS, *supra* note 6.

22. *See* Sarbanes-Oxley Act § 407.

23. *See infra* note 90 and accompanying text.

24. Sarbanes-Oxley Act § 403 (amending 15 U.S.C. § 78p).

25. *See* 68 Fed. Reg. 25788, 25789 n.37 (May 13, 2003) (referring to Ownership Reports And Trading By Officers, Directors And Principal Security Holders, Exchange Act S.E.C. Docket 944, Aug. 27, 2002 (to be codified at 17 C.F.R. pt. 240)).

forty-eight hours of the close of the transaction.[26] Another set of new requirements accelerates the timeline for filing periodic disclosure reports such as Forms 10-K, 10-Q, and 8-K.[27] These accelerated disclosure requirements produce increased costs in the form of increased staff hours, the addition of software to streamline filing processes, and expanded outside legal and auditor assistance.

In addition to accelerated and increased disclosure requirements, the SOA mandates that companies modify the audit committee of the board of directors to be comprised solely of independent members of the board.[28] This means that the independent members may not be compensated for reasons other than being on the audit committee.[29] The SOA also implies that companies should install at least one "financial expert" on the audit committee; if there is no expert on the committee, reasons why must be given.[30]

The mandatory addition of directors and a financial expert has the effect of increased overhead costs in the form of additional salaries; however, the salary of these executives is not the primary problem with the requirement mandating their participation in the administration of a company. The real problem lies in finding competent people that are willing to sit on the board and participate in the administration of public companies now that the SOA introduces such uncertainty regarding possible criminal and civil liability for officers and directors.[31]

The accelerated disclosure requirements of the SOA, the more stringent criteria regarding certification of financial statements, and the increased requirements on boards of directors have also impacted small

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26. *See id.* The transactions referenced are purchases and sales by insiders and "beneficial owner[s] of more than 10[%] of any class of any equity security" within the meaning given to such transactions by section 16 of the Securities Exchange Act of 1934. 15 U.S.C.S. § 78p (2003).

27. *See generally* SEC Final Rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, *available at* http://www.sec.gov/rules/final/33-8128.htm#P80_6485 (last modified Sept. 26, 2003) (summarizing timing of new reporting requirements); *see also* Carter Ledyard & Milburn LLP, Corporate Department Publication, *"Going Private" After The Sarbanes-Oxley Act of 2002," available at* http://www.clm.com/pubs/pub-1144369_1.html [hereinafter, "CLM web"].

28. *See* Sarbanes-Oxley Act § 301(a) (amending 15 U.S.C. § 78f); *see also* CLM web, *supra* note 27.

29. *See* Sarbanes-Oxley Act § 301(a) (amending 15 U.S.C. § 78f).

30. Sarbanes-Oxley Act § 407; *see also* CLM web, *supra* note 27.

31. In addition: "Members of audit committees face new burdens. [The SOA] and corporate governance initiatives by the New York Stock Exchange and NASDAQ generally require audit committees to more actively oversee companies' independent accountants and internal controls." Michael J. Levitin & Steven S. Snider, *Going Public: Been There, Done That, "Going Private" Now*, WASH. BUS. J. (Oct. 21, 2002), *at* http://washington.bizjournals.com/ washington/stories/2002/10/21/focus4.html.

public companies' balance sheets by forcing them to hire outside law and accounting firms.[32] These outside firms, in addition to the in-house training needed to bring employees up to speed with what new practices must be instituted to comply with the SOA, are adding up to unbearable costs for small companies.

For example, section 404 of the SOA provides that companies must retain outside accounting firms to report on management's assessment of the effectiveness of "internal control structure and procedures for financial reporting."[33] Apparently, the SEC previously considered establishing such a requirement, but never instituted one because of its expense.[34]

Many companies cite section 404 as the primary cost inflator of the SOA. "[The provision is] forcing companies to review, and in many cases change, a multitude of their basic, daily procedures—including how they maintain records, secure computerized data and handle inventory. Companies are paying hundreds of thousands and even millions of dollars to auditors as they scramble to comply."[35] For example: "Scientific Technologies Inc., which manufactures safety products in California, Utah and in a joint venture in Singapore, projects the cost of its compliance at $500,000 to $750,000. With about $60 million in annual sales, that's not insignificant."[36]

One of the indirect costs of complying with the SOA is the increase in insurance premiums that companies must pay to offset the personal liability of directors and officers.[37] Directors and officers insurance, has increased by approximately 30% to 40%.[38] The reason for the increase is that the SOA "spells out requirements for director actions in areas where boards previously had considerable discretion or wiggle room and thus heightens the probability of shareholder lawsuits for any fumbles that

32. *See* Tamara Loomis, *Sarbanes-Oxley Burdens Small Companies*, 228 N.Y. L.J. 1 (2002).

33. *See* Sarbanes-Oxley Act § 404.

34. *See* Fulcrum Financial Inquiry Report, *Going Private Becomes More Attractive*, at http://www.fulcruminquiry. com/article28.htm (last modified Nov. 2003).

35. Jonathan Peterson, *Corporate Reforms Irk Small Business*, LA TIMES, Jan. 16, 2005, at C1. At least the SEC has taken the complaints about section 404's onerous requirements seriously. "[SEC] officials announced the creation of an advisory panel of outside experts to consider the effect of Section 404 on smaller businesses." *Id.*

36. *Id.*

37. Tamara Loomis, *Socked by Sox*, Corporate Counsel (Jul. 1, 2003), http://www.law.com/jsp/cc/pubarticleCC .jsp?id=1055463668799.

38. *See* Murray Coleman, *More Companies Exit Public Markets*, INVESTOR'S BUS. DAILY, Aug. 26, 2003, at A-1 (quoting investment banker, Christopher Baclawski at CB Capital Partners); *see also* Levitin, *supra* note 31 (citing a report by Willis Group Holdings stating that "weaker companies can expect increases of as much as 400 percent.").

appear to violate the statute."[39]

Congress does not have a formal process for prospectively determining how much it will cost companies to comply with legislation like the SOA.[40] The only costs requiring estimates by the SEC in connection with implementing the SOA are those directly attributed to filing paperwork, namely the disclosure requirements.[41] Thus, the haste with which Congress passed the SOA caused a drastic increase in SEC compliance costs for public companies--costs that were never contemplated by legislators.

Adding to small companies' frustrations is the Congressional refusal to acknowledge any going private trend among small public companies. In fact, the House Committee on Financial Services published a report in 2003 that concluded that there is "no trend toward going private."[42] That House report, however, does not include any reference to what percentage of the companies cited are small versus what percentage are large.[43] The Securities Industry Association, on the other hand, researched how many of these companies going private were small, and concluded that the vast majority were indeed small companies.[44]

There are many specific examples across the country of the magnitude of costs small companies are incurring as a result of the SOA's requirements. One company in Port Washington, New York, with a net income of $300,000 and sales of $151 million in 2002, has to spend $250,000 a year to comply with the SOA.[45] Another company,

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39. *D&O Liability Insurance Rates Rise Amid Corporate Scandals*, 38 Mergers & Acquisitions: The Dealmaker's Journal 3, at 10 (Mar. 2003), *available at* http://majournal.nvst.com/sample/samplemaj.pdf.

40. According to Thomas McCool, head of financial markets and community investment at the General Accounting Office. *See* Nyberg, *supra* note 5.

41. Even though the SEC attempted to estimate those costs, the figures it reported were drastically low, according to senior management of many companies. *See id.*

42. The committee report states:

> Anecdotally, a handful of companies have reported that the costs associated with Sarbanes-Oxley's requirements of certification of financial statements, implementation of independent boards and audit committees, and accelerated company disclosures have forced them to go private. However, based on the number of pertinent SEC filings, there is little firm evidence that Sarbanes-Oxley is actually creating such a trend.

See REBUILDING INVESTOR CONFIDENCE, PROTECTING U.S. CAPITAL MARKETS, *supra* note 5. *But see* source cited *infra* note 44.

43. *Id.*

44. The Securities Industry Association's director of research was cited as saying that more than 75% of going private transactions in the eighteen months preceding September, 2003 involved small companies. *See* Ari Weinberg, *Small Companies Driven Out Of National Exchanges*, http://www.forbes.com/2003/09/09/cx_aw_0909private.html (Sept. 9, 2003).

45. *See* Del Jones, *Sarbanes Oxley, Dragon or white knight?*, USA TODAY, Oct. 20, 2003, at 01B, (showing the compliance costs of hardware wholesaler Moore-Handley).

based in Fort Worth, Texas, with a market cap between $3 million and $4 million, projected paying outside auditing and consulting firms $500,000 per year.[46] These SOA compliance costs are immensely disproportionate to costs of large companies like Wal-Mart, who had a $6.7 billion net income in 2002.[47] Billion dollar companies like Wal-Mart can afford to pay millions to comply because a few million dollars is only a small percentage of the company's gross income.[48] If compliance costs represent 83% of a company's income, however, as they do for the New York company mentioned above, that company will certainly seek to escape those inequitable costs by any method available.[49]

C. *The New NYSE and NASDAQ Rules, the Economy and Public Perception*

SEC rule 10A-3, promulgated under the SOA, directs the NYSE and the NASDAQ "to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements specified in Rule 10A-3."[50] As a result, the NYSE revised its manual to require all companies listed on the exchange to assemble their boards of directors with a majority of members being independent.[51] The NYSE manual also includes more stringent requirements for director audit and compensation committees, which supplement the requirements imposed by the SOA.[52] The NASDAQ has also imposed similar new

46. Maria Halkias, *Fort Worth, Texas-Based Garden Retailer Decides to Go Private to Cut Expenses*, DALLAS MORN'G NEWS, (No page), Sept. 19, 2003.

47. *See* Jones, *supra* note 45.

48. *Id.*

49. There is also evidence that the costs discussed above are not the only ones on the horizon for public companies. At least one journalist reports that:

> The Securities and Exchange Commission recently said it would be examining the entire proxy process, which is likely to result in making it easier for shareholder activists to avail themselves of the process at the expense of the company and weaken management's control of the process. Additionally, the Financial Accounting Standards Board has made it clear that it is all but certain to adopt a standard requiring the expensing of options. Also, measures are being considered that could require the mandatory splitting of the positions of chairman and chief executive officer between two individuals.

Bruce D. Knapp, *Public No More With Regulations Looming, Small And Midcap Companies Would Do Well To Go Or Stay Private,* PITT. POST GAZETTE, Aug. 26, 2003, at C9.

50. Notices, Self-Regulatory Orgs., Exchange Act Release No. 34-48745, 68 Fed. Reg. 64154, (Nov. 4, 2003) at 14-15. *See* 17 C.F.R. § 240.10a-3 (2003).

51. Notices, Self-Regulatory Orgs., Exchange Act Release No. 34-48745, 68 Fed. Reg. 64154, (Nov. 4, 2003) at 16-17.

52. *Id.* at 27-28.

requirements, including director independence.[53] These obligatory requirements by the NYSE and the NASDAQ only add to the burden small companies are facing as a result of the SOA.

The current state of the U.S. economy, including the state of capital markets, coupled with the public perception of public companies, are additional and substantial factors driving companies to go private. The effect of U.S. public companies losing a combined $7.7 trillion in market capitalization[54] has caused many of those companies to lose the ability to attract investors, use public stock to acquire other companies, and provide liquidity for employees wishing to exercise options.[55]

Furthermore, the lack of financial industry analyst coverage[56] for small companies "often negates the liquidity that is typically associated with publicly owned shares."[57] The prestige and good-will propelled upon public companies during the stock market boom of the 1990s has evolved into skepticism and outright contempt for public companies and their executives.[58] This loss of prestige and increase in ill-will is partly attributable to the relentless media coverage of federal prosecutions of corporate executives.[59] The equally relentless prosecution of these executives and of the financial analysts associated with them by zealous officials like New York State Attorney General Eliot Spitzer has only added to negative public perception.[60]

Although the economy, stock market, and popular perception have all contributed to companies' wishes to exit the public markets, the ultimate factor has been the enactment of the SOA.[61] Without the SOA,

53. *Id.* at 46-70.

54. *See* Hernandez, *supra* note 2 (defining "market capitalization").

55. Levitin, *supra* note 31; *see also* Bruce D. Knapp, *Public No More With Regulations Looming, Small And Midcap Companies Would Do Well To Go Or Stay Private,* PITT. POST GAZETTE, Aug. 26, 2003, at C9.

56. Analyst coverage is necessary in order to create interest by potential investors in a company, driving up demand for the stock, and resulting in a higher valuation for the company.

57. *See Knapp, supra* note 49.

58. *See id.*

59. *See, e.g.,* Mark Gongloff, *Bush seeks new business ethic: In speech on Wall Street, president wants longer jail terms, tougher laws to curb corporate abuses,* CNN MONEY, *at* http://money.cnn.com/2002/07/09/news/bush/ index.htm (July 9, 2002); *see also* Max Baucus, Charles E. Grassley and John McCain, Editorial, *A Second Betrayal,* WALL ST. J., Mar. 13, 2003, at A12 (discussing the need for stricter punishment for corporate wrongdoers).

60. *See* Deborah Solomon, *Zealous States Shake Up Legal Status Quo,* WALL ST. J., Aug. 28, 2003, at A4 (discussing Spitzer's wish "to extend new accounting checks beyond publicly traded corporations. . . .").

61. In a PriceWaterhouseCoopers survey of Chief Executives around the Globe taken at the Davos, Switzerland World Economic Forum, CEOs cited "over-regulation" as "one of the biggest threats to their growth prospects." The survey also revealed that "[g]overnment is also seen as a threat to growth. In fact, almost half of the CEOs

the new NYSE and NASDAQ rules may have never been imposed or could have been more gradually phased in over a longer period of time. In addition, the prosecution of corporate criminals would arguably be more difficult without the SOA.[62]

D. Going Private

1. Definitions and Procedure

Many small public companies that are suddenly faced with the onerous costs of complying with the SOA have decided that the only way to avoid these costs is to "go private." The SEC defines "going private" as reducing the number of shareholders in a company to less than 300, thereby escaping the SEC's reporting requirements.[63] Although this comment focuses on the definition provided by the SEC, there is more than one way to go private.[64] The scope of this comment is limited to a general analysis of federal securities law issues involved in going private.[65]

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surveyed feel that government is out of touch with business needs." *See PricewaterhouseCoopers' Global CEO Survey Reveals Overwhelming Confidence in Business Outlook for 2003*, at http://www.pwcglobal.com/Extweb/ncsurvres.nsf/docid/3E209C17DCA1262C85256CBD0044B10F (Jan. 23, 2003) (on file with author).

62. Although the SOA makes it easier for the Department of Justice to prosecute corporate executives, New York Attorney General Eliot Spitzer relies on New York's securities fraud statute, the Martin Act. *See* N.Y. GEN. BUS. LAW § 352-c (2003).

63. *See* SEC Fast Answers, *"Going Private," at* http://www.sec.gov/answers/gopriv.htm (last modified Aug. 9, 2004).

64. Multiple definitions of going private transactions can be found. *E.g.*, a treatise titled *"Going Private"* states: "A 'true' going private transaction . . . is one by which an individual or a group of individuals controlling a public corporation by virtue of an impregnable stock position, . . . undertakes a corporate transaction in order to acquire, either immediately or on a deferred basis, the entire equity interest in the corporation." BORDEN ARTHUR M. & YUNIS JOEL A., GOING PRIVATE, § 1.02, at § 1.02 (15th ed. 1997); *see also* MARC MORGENSTERN & PETER NEALIS, GOING PRIVATE: A REASONED RESPONSE TO SARBANES OXLEY?, (SEC 23rd Annual Government-Business Forum on Small Business Capital Formation Sept. 20, 2004) (stating:

> The broad vernacular of "going private," encompasses two events so dramatically different that they should never be referred to under a common rubric. The conventional reference to a company "going private" is in regard to a major organic corporate transaction. Common structures are leveraged buy-outs ("LBOs") or management buy-outs ("MBOs"). A "going private" deal typically dramatically alters the control, capitalization, and ownership composition of a public company. The second reference is to a "delisting" or "deregistration" process pursuant to which a public company makes a transition to being a non-reporting company.).

65. Delaware law is the only state law discussed. A brief state law analysis is limited to Delaware because of that state's leadership position in corporate law matters and recent decisions involving risks to minority shareholders in going private transactions.

Thanks to the internet boom of the 1990s and the high stock market participation rate of Americans,[66] the vast majority of Americans know what a public company is.[67] When a company's shares are publicly traded, vast amounts of capital are available for use at the company's discretion.[68] However, the recent depressed state of the equity markets in several industry sectors has led to a dwindling of many public companies' market capitalizations.[69]

Small public companies, the ones with the lowest market capitalizations, are still forced to partake in what are viewed as "cornerstones of US capital markets," that is, "disclosure regulation and associated enforcement."[70] These obligations, augmented by the SOA, are necessary for transparent company operations and investor confidence. These obligations, however, are also a major component of what is prompting small public companies to exit the public markets and go private.

On its website, the SEC uses three types of transactions as examples of how a public company goes private.[71] The three transactions occur when: (1) "Another company or individual makes a tender offer to buy all or most of the company's publicly held shares;"[72] (2) "The company merges with or sells the company's assets to another company; or"[73] (3) "The company . . . declare[s] a reverse stock split that not only reduces the number of shares but also reduces the number of shareholders."[74]

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66. *See* Daniela Deane, *Property Owners Build Wealth Slowly but Surely*, WASH. POST, Mar. 19, 2003, at H1 (citing the Federal Reserve for stating that 52% of Americans own stock).

67. Advantages to being a public company include unlimited access to capital (at least theoretically), shareholder liquidity and the ability to attract qualified personnel with stock options. *See* Stephen J. Redner, *Thinking Of Going Public? Think Twice, Then Read The Sarbanes-Oxley Act Of 2002*, 6 J. SMALL & EMERGING BUS. L. 521, 522 (2002). *But see* Knapp, *supra* note 49.

68. *See id.*

69. *See* David A. Stockton et al., *Going private: The Best Option?*, NAT'L LAW J., June 23, 2003, at 19.

70. *See* Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation* (Wharton Financial Institutions Center, Working Paper No. 02-24-B, 2003).

71. *See "Going Private," supra* note 63. These three transactions are sufficient for the purposes of this comment.

72. A "tender offer" has been defined as a "general, publicized bid by an individual or group to buy shares of a publicly-owned company, the shares of which were traded on a national securities exchange, at a price substantially above the current market price." Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 54-55 (2nd Cir. 1985).

73. *See "Going Private," supra* note 63.

74. *Id.* A reverse stock split is defined by Black's as "[a] reduction in the number of a corporation's shares by calling in all outstanding shares and reissuing fewer shares having greater value." BLACK'S LAW DICTIONARY 1432 (7th ed. 1999).

For the purposes of this comment, the public markets referred to above are necessarily limited to the two previously mentioned dominant national exchanges: the NYSE and the NASDAQ.[75] Companies registered on these two exchanges initially had to meet the registration requirements of Section 12 of the Securities Exchange Act of 1934 in order to achieve registration.[76]

To de-register and go private, companies registered under Section 12 must file a form certifying to the SEC that they meet the requirements for de-registration.[77] Preceding the successful filing of this form, a company has to remove itself from the exchange or quotation system to which it belongs. In this manner, the company no longer has to meet the disclosure requirements of the SEC.

Rule 13-e3 of the Securities Exchange Act of 1934 requires companies effecting any of the three types of going-private transactions described above to disclose certain information to security holders.[78] This disclosure is in addition to the requirements of Section 12 for de-registration from an exchange or quotation system.[79]

2. Reasons for the Popularity of Going Private

The SOA has been cited as the principal motive for many recent or pending going private transactions.[80] However, the additional reasons that proponents of going private give to bolster their argument are also compelling if looked at with an uncritical eye. Reasons include decreased liquidity and less access to capital markets for many small public companies that have lost much of their value in the recent downward trend of the stock market.[81] The ability of private companies to focus on long-term goals and strategy, as opposed to always "operating the company to simply satisfy the forecast for next quarter's earnings," has also been cited as a benefit of going private.[82]

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75. *See* 17 C.F.R. § 240.13e-3(e)(a)(ii)(B) (2003).

76. *See* 15 U.S.C.S. § 781 (2003) (codifying the Securities Exchange Act section 12(b) under which NYSE companies are registered and section 12(g) under which NASDAQ companies are registered).

77. *See* 17 C.F.R. § 240.12g-4 (2003).

78. *See id.* § 240.13e-3(e).

79. *See id.* § 240.13e-3(e)(1).

80. *See supra* notes 44-46 and accompanying text.

81. *See* Lawrence H. Gennari, *Guest Commentary: Let's take this offline: Sarbanes-Oxley and 'going private'* (Gadsby Hannah LLP, Boston, Mass.), *at* http://www.ghlaw.com/html/05publications/1articles/GuestCommentary-Gennari2003.htm (last visited Jan 24, 2005).

82. Cristy Lomenzo Parker, *"Going Private": Business and Procedural Considerations in Seeking Relief from Reporting and Corporate Governance Requirements* (Rutan & Tucker LLP, Costa Mesa, Cal.), *at* http://www.rutan.com/pdf/GoingPrivate.pdf (Mar., 2003).

Another cited benefit is informality of corporate governance in private, closely held companies.[83] Informality is said to allow business flexibility as well as decreased exposure to class action securities litigation arising from non-timely or incomplete SEC disclosure.[84] Some commentators say that going private now may lead to a profitable future sale or may allow companies to revert to being public in the future, at which time they can "reap the attendant benefits."[85] However, as shown in Part III of this comment, all the above reasons are eclipsed by the costs, possible liability, and long-term detriment associated with going private.

III. Analysis

A. Reasons to Avoid Going Private

Going private is generally not the proper response to the increased costs associated with being a public company. Although many law firms nationwide promote the use of going private and de-registering as a useful way to avoid compliance costs in the short term, this is usually not the best long-term strategy for companies seeking continuing growth. In addition, the costs of going private are not insignificant, and the possible liability to shareholders is considerable.

As an initial matter, most large companies' senior executives expect that the costs of compliance with the SOA will remain constant or decline over time.[86] Costs for small companies should also remain the same or decline because once the systems required for compliance are in place, the initial implementation costs will disappear.

Being a public company necessitates a higher level of responsibility to shareholders than being a private company. Along with this responsibility comes regulation, in the form of the SEC regulations discussed in this comment, that are augmented by the SOA. Those regulations mandate transparency of corporate operations, executive accountability for the truth of financial statements, and fairness in dealings with shareholders.[87] Companies should not seek to go private simply to escape these responsibilities because these responsibilities represent the manifestation of an American system of business values.

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83. *See id.*

84. *See id.*

85. *See* CLM web, *supra* note 27.

86. *See Senior Executives At Large Multinational Companies Divided on Cost of Complying with Sarbanes-Oxley Act,* at http://www.pwcglobal.com/extweb/ncpressrelease.nsf/DocID/BF54349CBB406BB585256D5600687C63 (July 1, 2003).

87. *See supra* notes 24-27 and accompanying text.

However hastily the SOA was passed, the purpose of it is to ensure behavior that was already required before its passage.[88] Even private companies will now seek to comply with the SOA because the practices it mandates will become a standard that all companies must live up to.

The price tag of a going private transaction is not a factor that should be overlooked by those willing to take their companies private.[89] Investment banking firms, law firms, and accounting firms are all necessary advisors to a going private transaction.[90] In addition to the direct advisors to the company, there is also a group of advisors to any independent board of directors "appointed to evaluate the fairness of the offer on behalf of the public shareholders."[91] The whole process can take months.[92]

Also to be considered is the expense of the proxy solicitation process. In order for any company to effect a going private transaction, depending on state law and the articles of incorporation, the majority of shareholders of the company must vote affirmatively.[93] Depending on the number of shareholders, the cost of mailing all the required information[94] can be significant.

The long term strategy for many small private companies is often to go public in order to grow or to be bought by a larger, public company.[95] Companies that are now public are choosing to go private to avoid costs associated with the SOA. Many companies, however, will want to go

88. *See supra* note 10 and accompanying text.

89. Companies wishing to go private often do so by a buyout by management (MBO), which can put such a strain on a company because of the debt acquired to effect the buyout that the company may be forced to pursue bankruptcy. For example, a company named Maxxim Medical went bankrupt because of the debt it acquired in order to go private. *See* Nevin Sanli & Tom Pastore, *Remaining Public—The Best Option in Troubled Markets?* (SP&H, Inc., Los Angeles, Cal.), *at* http://www.businessnation.com/library/articles/pages/Articles/372-RemainingPublicArticle.pdf (July 17, 2003).

90. *See* Grant Thornton LLP, *Public companies explore "going private" in today's uncertain economic climate*, *at* http://www.grantthornton.com/content/84763.asp (on file with author).

91. *See id.* (stating that "this is on top of coming up with the capital to buy out the public shareholders. In most cases, this capital may be more expensive than the cost of the capital as a public company, thereby putting a financial burden on the company and restraining investment for growth."). *Id.*

92. *Public companies weigh benefits of going private*, ST. LOUIS BUS. J., *at* http://www.bizjournals.com/ stlouis/stories/2003/06/23/focus2.html?t=printable (on file with author).

93. *See* BORDEN & YUNIS, supra note 64 § 13A.11.

94. *Id.* ("The proxy statement will notify the public stockholders of the date, time and place of the meeting of the stockholders to adopt and approve the [transaction].").

95. For example, venture capitalists, which fund many start-ups generally have two goals in mind when funding a private company. One goal is for the company to be bought at a favorable price and another is for the company to go public. *See* Loomis, *infra* note 99.

public again or be acquired if they wish to maximize growth or maximize profits. To do this they will re-incur the cost of going public, which is very expensive.[96] This is terribly inefficient because they have previously gone public.

Additionally, large public companies interested in acquiring smaller companies are increasing their scrutiny of the corporate governance practices of their targets.[97] This means that private companies with an exit strategy tied to acquisition must follow the general practices outlined by the SOA regardless of whether the company is subject to SEC reporting.

Another reason why going private can cause great detriment to a company and its shareholders is the almost certain shareholder actions[98] that would be filed as a result.[99] Section 13(e) of the Securities

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96. One business valuation firm in Los Angeles that advocates remaining private does a nice job of generally outlining the costs, writing that:

> The most significant cost is the underwriter commission, which generally costs about 7% of the offering size but can cost significantly more, on a percentage basis, depending on the size of the offering. Then, of course, there are legal fees, accounting and auditing fees, printing fees, SEC and state registration fees, listing fees or quotation fees, and company expenses for travel and road show requirements. Total fees may reach 9% - 20% of the offering. Thus, the total cost of capital to round-trip back to the public markets may be much more expensive than just remaining a public company.

See Remaining Public—The Best Option in Troubled Markets? (Sanli Pastore & Hill, Inc., Los Angeles, CA), *at* www.sphvalue.com/pdf/remaining_public.pdf (Jul. 17, 2003).

97. "Lenders and public companies seeking to acquire private companies are stepping up their levels of scrutiny and due diligence, says Trent Gazzaway, national director of corporate governance advisory services for Grant Thornton in Charlotte, N.C." Robert J. Derocher, *Circles of Influence: The long arm of Sarbanes-Oxley touches the private as well as the public sector—and that might not be so bad, at* http://www.insight-mag.com, (on file with author). In addition "[p]rivate companies better have their corporate governance environment in control . . . because it's going to be looked at by the acquiring company and it may affect the value of what's being sold." *Id.*

98. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) (stating that a shareholder in a derivative action "step[s] into the corporation's shoes and . . . seek[s] in its right the restitution he could not demand in his own")); *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (holding that "[t]he nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it."); Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) (stating that "[T]he rule is so well settled as to require no citation of authorities" that when officers commit fraud, proper action is derivative).

99. Going private attracts intense scrutiny from shareholders seeking to maximize their stock price. According to one corporate securities lawyer, going private transactions are "almost always subject to litigation." Paula Moore, *'Going Private' Not as Simple as It Sounds*, DENVER BUS. J., http://denver.bizjournals.com/denver/stories/2003/04/21/smallb1.html?t=printable (Apr. 21, 2003); *see also* Tamara Loomis, *Costs of Compliance Soar After Sarbanes-Oxley*, May 2, 2003, 228 LEGAL INTELLIGENCER (Philadelphia) 85 (stating that shareholder suits are "almost inevitable" in going private transactions).

Exchange Act of 1934 requires certain disclosures by companies seeking to go private.[100] If the required disclosures are not made or are inadequate in a material way, SEC Rule 13-e3,[101] promulgated under the 1934 Act, allows for a private right of action.[102]

The reason rules like 13-e3 exist is that investors must be protected from possible abuses of insiders initiating certain types of going private transactions. For example, in a purchase and sale of assets, where the acquiring company includes a controlling shareholder, the opportunity for abuse of minority shareholders is always present. This opportunity arises as a result of the "inherently coercive nature"[103] of going private transactions, including the power of majority shareholders to force minority shareholders to tender their shares at a price set by the majority.[104]

As with any fundamental corporate change, going private is subject to state law standards governing the fiduciary duties of corporate directors.[105] At least one commentator, however, has noted that the SOA "represents another instance of federal intrusion seeking to compensate for lax standards at the state level."[106] According to this commentator, the SOA amplifies directors' duties, "largely supplanting Delaware law concerning the duty to monitor" officers, employees, and the whole corporate governance process.[107] Nevertheless, Delaware law is still relevant in the context of fiduciary duties of directors effecting transactions such as going private.

Delaware courts apply the fiduciary duties of care and loyalty, including fair dealing and fair price, when a going private transaction occurs in the form of a merger.[108] If the minority shareholders believe

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100. *See supra* note 78 and accompanying text.

101. *See* 17 C.F.R. § 240.13e-3 (2003).

102. This right is implied. *See* Howing Co. v. Nationwide Corp. 826 F.2d 1470, 1474 (6th Cir. 1987).

103. *Id.* at 1476 (stating that "minority shareholders are forced to exchange their shares for cash or other consideration. The coercive effect of these transactions is reinforced by the fact that the majority shareholders control the timing and terms of the transaction.").

104. *See id.*

105. *See* Cristy Lomenzo Parker, *"Going Private": Business and Procedural Considerations in Seeking Relief from Reporting and Corporate Governance Requirements* (Rutan & Tucker LLP, Costa Mesa, Cal.), http://www.rutan.com/pdf/GoingPrivate.pdf (Mar. 2003).

106. J. Robert Brown, Jr., *The Irrelevance Of State Corporate Law In The Governance Of Public Companies*, 38 U. RICH. L. REV. 317, 374-375 (Jan. 2004).

107. *Id.* at 375.

108. *See* Gregory J. Schwartz, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image*, 35 CATH. U.L. REV. 489, 496-515 (1986) (discussing "Delaware's fiduciary duty of fair dealing and fair Price in the going private merger context" using the following four cases: Singer v. Magnavox Co., 380

they have not been treated fairly, as they often believe, they can bring a derivative action against the corporation, resulting in great detriment to the corporation.[109] The expense and possible liability involved in defending these kinds of suits is not insignificant and should be considered carefully by any company wishing to go private in order to avoid expenses.[110]

B. Escaping the Perceived Necessity to Go Private

Under the authority given to the SEC in the SOA, that agency should promulgate rules that exempt small public companies from certain requirements.[111] The SOA states that the SEC may, at its discretion, provide exemptions from some rules required to be made under the statute.[112]

Alternatively, or in conjunction with exempting small companies from certain requirements, Congress and the SEC should establish several levels of compliance to correspond with the companies' abilities to comply and maintain a healthy bottom line.[113] After all, one of the primary missions of the SEC[114] is to level the playing field and make the capital markets accessible to all, including small companies.[115]

A.2d 969, 971 (Del. 1977), Tanzer v. International General Industries, 379 A.2d 1121 (Del. 1977), Roland Int'l. Corp. v. Najjar, 387 A.2d 709 (Del. Ch. 1978), Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)).

109. Another expense to consider is the premium that one must pay above the share price at the time of the going private transaction if one is buying shares. *See* BORDEN & YUNIS, *supra* note 64 (citing Houlihan, Lokey, Howard and Zukin, Mergerstat Review 1997 (1997) as saying that "annual comparisons of the average premiums offered over the then prevailing trading price in merger transactions, Mergerstat found that the median premium to market price for going private transactions from 1987 through 1996 varied from 8% to 35%").

110. Even though being public may subject directors to shareholder lawsuits arising from violations of the SOA, these suits were already a possibility under earlier securities law such as Rule 10-b5. *See* 17 C.F.R. § 240.10b-5 (2003). The only new express private right of action provided for in the SOA is for employees who are discharged or suffer other discrimination due to "whistleblowing" on securities law violations. *See* Sarbanes-Oxley Act § 806 (amending 18 U.S.C. § 1514).

111. *See* Knowledge@Wharton, *Do High Regulatory Costs Force Public Firms to Go Private?*, *at* http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&ID=847 (Sept. 10, 2003) (quoting Wharton Business School Professor Christial Leuz, as saying that "regulators may wish to consider establishing multi-tiered equity markets featuring a variety of standards").

112. *See, e.g.*, Sarbanes-Oxley Act § 301(3)(C) (amending 15 U.S.C. § 78f) (authorizing the SEC to exempt companies' audit committee members from independence requirements).

113. *See id.*

114. *See generally* Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1969) (discussing purposes of Securities Exchange Act, the legislation that created the SEC).

115. Another policy consideration for Congress is that "[c]hasing away small

The NYSE and NASDAQ should also consider relaxing their rules in conjunction with more lenient SEC mandated levels of mandatory SOA compliance for small public companies. Without a more relaxed regulatory environment for small public companies, the trend towards going private is likely to continue and may burgeon.

IV. Conclusion

While the SOA has imposed a heavier burden on small companies that are a part of the public markets, these burdens come with advantages[116] that outweigh the possible short term benefits of reverting to private status. Along with being a public company comes greater fiduciary responsibility. That accountability is now greater than ever because of the recent abuses of the trust placed in the fiduciaries that managed companies like Enron and WorldCom.[117]

Specific examples of companies like the ones in New York and Texas discussed in Part II.B which chose to go private because of the SOA are plentiful. These companies' experiences should be the exception and not the norm. Going private is the right solution for some companies but should not be used as a universal remedy for avoiding regulatory compliance costs because being a public company is so advantageous and the economic climate and public perception are already starting to improve.

Most companies should not attempt to avoid the new responsibility cast on them by the SOA because in the long term, the legislation should be amended and interpreted to further the American economic policies favoring small businesses. Until then, small public companies should weather the current upsurge in regulatory costs and adopt a wait-and-see attitude.

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companies—the lifeblood of the economy—from new funding could become a significant economic detriment." *See* Ari Weinberg, *Small Companies Driven Out Of National Exchanges*, http://www.forbes.com/ 2003/09/09/cx_aw_0909private.html (Sept. 9, 2003) (quoting the Securities Industry Association Director of Research, as saying "[a]s a whole, [small companies] hire more, are more productive and bring about more innovations . . . large firms prompted [the enactment of the SOA], but the ones penalized as a result are the small businesses.").

116. *See* Redner, *supra* note 67.

117. *See supra* notes 12-13 and accompanying text.